# EXECUTIVE COMPENSATION PLAN INVALID FOR LACK OF REASONABLE RELATION TO SERVICES RENDERED

*Berkwitz v. Humphrey,*
*163 F. Supp. 78 (N.D. Ohio 1958)*

In a stockholder's derivative suit, plaintiff objected to the Management Unit Plan, a profit sharing and pension plan adopted by the Pittsburgh Consolidation Coal Company for the benefit of its top level executives. Under the plan, certain key employees were assigned a designated number of units. Upon retirement at age sixty-five or upon termination of employment at any time due to sickness or death, the company agreed to pay the unit holders a sum equal to the increased value of the units to which an employee was entitled measured by the increased value, if any, of an equal number of shares of capital stock. Thus an employee who participated in the plan for five years would be given a bonus upon retirement equal to the number of units he held multiplied by the rise in the market value of the capital stock during the period in which he participated in the plan.

The federal district court for the northern district of Ohio held that such a plan was unreasonable per se and invalid because the method of computing the compensation bore no reasonable relation to services rendered and was therefore a misuse of corporate funds.[1]

The court, having acknowledged the fact that it was dealing with a singular case of first impression, began its examination of the plan by stating the well settled principle that the "authorized compensation must bear a reasonable relation to the value of the services of an employee."[2] The first objection to the plan raised by the court was that the market value of the capital stock of a corporation is an unreliable index of the value of services rendered by its key employees as it is governed by many aleatory considerations.

This same problem was discussed in *Gruber v. Chesapeake & O. Ry.*[3] where the court said:

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[1] Berkwitz v. Humphrey, 163 F. Supp. 78 (N.D. Ohio 1958).

[2] Rogers v. Hill, 289 U.S. 582 (1933); Gallin v. National City Bank, 273 N.Y.S. 87 (1934).

[3] 158 F. Supp. 593, 597 (N.D. Ohio 1957). The principal case and the *Gruber* case were both decided by the federal district court for the northern district of Ohio. The *Gruber* case was cited by the defendants in their motion to dismiss but was not referred to in the opinion. It involved a stock option plan whereby certain executives were given the opportunity to purchase company stock at prices below market value. Such a plan bears a resemblance to the Management Unit Plan in that whether the executive makes a profit above and beyond the discount given him at time of purchase, depends upon the subsequent conduct of the market value of the stock. The obvious difference is that the executive may sell his stock at any time whereas the executive assigned units must wait until

> [I]t has become a business custom that corporation executives are given a proprietary interest in the company for which they work, through the granting of common stock at its present market price. The executive's "benefit" materializes when the stock which he has received rises in price on the market through increased efficiency in management and operation of the company.

The court in the *Gruber* case clearly indicated that there is some reasonable relation between services rendered and the market value of the stock, whereas the court in the principal case held that there is no reasonable relationship between market value and services rendered.

The court held the plan unreasonable per se, thus ignoring the fact that the retirement bonuses paid out from 1947 to 1952 amounted to only 1.71 per cent of the dividends paid to stock holders.[4] The court employed the familiar device commonly known as "the parade of the horribles" to show just what sort of incongruous results *might* be reached by the use of such a plan. Again the court shut its eyes to the actual results achieved by the plan during the first five years of operation.

In stockholders derivative suits such as this, the courts place the burden of proof on the stockholder who challenges the plan and require him to sustain it by showing that the excessive compensation stems from fraud or bad faith practiced by the directors.[5] Reasonableness of executive compensation is clearly a relative matter and lies in an area where the courts have not required exact precision but have been satisfied with rough approximation. In the principal case, plaintiff does not object to the retirement bonuses as being "excessive" but only as being "unreasonable." However, it is apparent that plaintiff's real objection is that, in the future, the plan may result in excessive compensation for the participants, thus cutting into plaintiff's right to the profits by way of dividends.

Generally, the courts have not considered compensation plans to be excessive per se, but have compared the amounts with benefits paid by other companies.[6] In *Kalmanash v. Smith* the court required the com-

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retirement to realize any profit upon an increase in market value. Both plans give the executive the incentive to work at his most productive level in order to maximize profits and thus increase the value of the stock. However, once the stock has been sold, the executive no longer has such an incentive. Such a result is not possible with the Management Unit Plan, where the incentive is present up to the day of retirement.

[4] Brief for Defendant, p. 19, Berkwitz v. Humphrey, 163 F. Supp. 78 (N.D. Ohio 1958). During the five year period from 1947 to 1952 the dividends paid to stockholders amounted to $32,391,000.00. The retirement bonuses paid out to employees amounted to $55,408.00.

[5] Heinz v. National Bank of Commerce, 237 F. 942 (8th Cir. 1916); Gottfried v. Gottfried, 112 N.Y.S.2d 431 (1952); Kalmanash v. Smith, 291 N.Y. 142, 51 N.E.2d 681 (1943); CCH 1 PENSION PLAN RULINGS ¶ 10201 (1954); 5 FLETCHER, PRIVATE CORPORATIONS §§ 2126, 2129 (perm. ed. rev. repl. 1952).

[6] WASHINGTON & ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 371 (1951).

plaint to state the amounts received by the executives and the services performed as part of the factual showing of excessiveness.[7] The court relied heavily upon *Rogers v. Hill*,[8] probably the most famous of all stockholder litigation and the source of the principle that compensation must be reasonably related to services. However, that case held that the *amount* paid to the president of The American Tobacco Company was unreasonable, not that the *plan* whereby the figure was computed was unreasonable. In the *Kalmanash* case the court said that in a stockholder's derivative action, allegations that the corporation's payments to certain officers thereof amounted to spoilation or waste of corporate funds did not plead an actionable wrong in the absence of allegation of facts showing bad faith or fraud practiced by the officers. Such a statement as this is the result of the application of the "business judgment rule," whereby the courts defer to the honest judgment of the directors on questions of corporate management and policy.[9]

In the principal case there is a conspicuous absence of any proof of excessiveness of amount of the bonuses or of fraud or bad faith on the part of the directors. The plan had been in operation only a few years. To say that in the future these retirement bonuses will be excessive is to substitute the business judgment of the court for the business judgment of the corporation. This is the very thing that the business judgment rule was designed to prevent.[10] When the soundness of a management decision is questioned and the results of that decision are *in futuro*, the business judgment rule requires that the court "render unto Caesar that which is Caesar's." In a situation such as this, a holding that the decision

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[7] 291 N.Y. 142, 51 N.E.2d 681 (1943).

[8] 289 U.S. 582, 591 (1933). "As the amounts payable depend upon the gains of the business, the specified percentages are not *per se* unreasonable. . . . [T]he payments under the by-law have by reason of increase of profits become so large as to warrant investigation in equity in the interest of the company."

[9] "[T]he court will not interfere with the internal management of corporations, and therefore will not substitute its judgment for that of the officers and directors." Otis & Co. v. Pennsylvania R.R. 61 F. Supp. 905, 911 (E.D. Pa. 1945); *aff'd*, 155 F.2d 522 (3d Cir. 1946). "Questions of policy of management, of expediency of contracts or action, of adequacy of consideration not grossly disproportionate, of lawful appropriation of corporate funds to advance corporate interests, are left solely to the honest decision of the directors. . . . To hold otherwise would be to substitute the judgment and discretion of others in the place of those determined on by the scheme of incorporation." Ellerman v. Chicago Junction Ry., 49 N.J. Eq. 217, 232 (1891). See Merriman v. National Zinc Corp., 82 N.J. Eq. 493, 89 Atl. 764 (1914); CCH 1 PENSION PLAN RULINGS ¶ 10201 (1954); Carson, *Current Phases of Derivative Actions Against Directors*, 40 MICH. L. REV. 1125, 1128-1131 (1942); See also 5 FLETCHER, PRIVATE CORPORATIONS §§ 2126, 2129 (perm. ed. rev. repl. 1952).

[10] In *Gottfried v. Gottfried*, 112 N.Y.S.2d 431, 461 (1952) the court said that there is no simple test available to determine when an incentive compensation contract keyed to employer's profits is wasteful and that the courts are loath to overturn a contract particularly when "the only defect claimed is that as things worked out the contingent compensation proved to be excessive."

of the directors is unreasonable per se is a trespass by the court upon the domain of the corporation directors.

In addition to the main objection of "unreasonableness," the court stated that the company was aware of the fact that the market value of the stock bore no reasonable relation to services rendered and this was why the company provided a two year extension for determining the value of the stock.[11] The defendant stated in its supplemental brief that the purpose of the two year provision was to give the employees a chance to capitalize on the fruits of their labor which might not be transformed into market appreciation at the time of retirement. It would seem clear that the reflection of valuable services in the rise of the corporate stock would not be an instantaneous operation.

Since two top executives did not participate in the plan the court reasoned that their services contributed to the increase in the value of the capital stock, and yet others reaped the benefits from their labor. This objection could be brought against the plan even if these two men had joined, since through their positions and abilities they effectively controlled the policy of the company. But more important, this criticism by the court recognizes that the valuable leadership and services of these two men *did* result in a rise in the market value of the stock.

The court vigorously objected to the plan because of the influence on the stock of non-recurring capital gains derived from the sale of assets in transactions where only one or two executives participate but in the fruits of which all of the unit holders would share. Such a criticism does not take into consideration the fact that one of the assumptions underlying profit sharing plans is that the efforts of all key personnel helped to provide the company with the asset now being sold. Since unit holders would suffer from non-recurring losses, it seems only fair to permit them to share in non-recurring gains.

One of the main reasons for instituting such a plan was to furnish an incentive for the employees to remain with the company and put forth their best efforts. The training of a top executive involves an expense which the corporation would like to amortize over a long period. In speaking of profit sharing plans, the court in the *Gruber* case said:

> The company is compensated by increased profits, ultimately distributed to the shareholders through dividends, and elicited to a great extent by that continuity of service on the part of its executives which would otherwise be frustrated.[12]

A $51,000 bonus paid to the chairman of the board of directors of

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[11] The plan as originally instituted provided a five year period extending from date of retirement during which the retired employee could select a market value date which would serve as the basis for computing his bonus. The plan was amended to provide for a two year period and any date chosen during this period had to be designated ten days in advance.

[12] Gruber v. Chesapeake & O. Ry., *supra* note 3, at 597.

Republic Steel was held valid as incentive for his continued valuable services.[13]

A retirement plan such as that of Pitt-Consol serves as one method of hedging against inflation. In an inflationary economy, a retirement bonus determined by prior income gives to the employee a dollar valuation which does not represent the purchasing power that it did at the time the right to the bonus was earned.[14] Many pension plans which are automatically adjusted to the cost of living continue to do so even after the employee has been retired.[15] Since studies show that there is a correlation, though not exact, between stock prices and cost of living,[16] it would seem that the Pitt-Consol plan has this valuable built-in feature.

Conceding that the benefits paid out under any compensation plan must bear a reasonable relation to the services rendered, this does not require a finding of more than that the total compensation paid out is related to the total benefits received. Thus it has been suggested that the existence of this relationship should not be tested by whether the corporation will receive from any individual employee services in the future commensurate with the pension to be paid him, but rather by whether the overall cost of the pension plan will be offset by the total benefits arising from the existence of the plan.[17]

The decision in this case reduces the sphere of operations in which corporate directors can move without fear of judicial intercession. It also tends to neutralize the effectiveness of the business judgment rule.

Since many other companies have adopted the Management Unit Plan or a similar system for compensating their executives, the importance of this decision is clear. Because this is a case of first impression, it sets a trend which may be followed by other courts. The validity of these other plans will depend upon their factual similarity to the Management Unit Plan and whether the court will withhold its judgment until it can be ascertained whether or not the amounts actually paid out were excessive.

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[13] Holmes v. Republic Steel Corp., 84 Ohio App. 442, 84 N.E.2d 508 (1948).

[14] Calvert, *Taking the Gamble Out of Pensions,* 51 PUB. UTIL. FORT. 415 (1953); 1 P-H CORP. SERV. ¶ 25048 (1957).

[15] 1 P-H CORP. SERV., *supra* note 14. *E.g.,* an employee accrues a pension unit of $100 in 1956 and the cost of living in that year is 116. If at retirement, the cost-of-living index stands at 140, that particular pension would be adjusted by multiplying $\frac{140}{116}$ x 100. The result is an adjusted pension unit of $121. Many plans continue this adjustment even though the employee has been retired for many years.

[16] *Ibid.*

[17] Note, 70 HARV. L. REV. 490 (1957).